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Standards Overload and Differential Reporting

Public accountants and managers of small and private businesses have complained that the standards set by the FASB:

(a) are unduly burdensome for them to meet, and

(b) yield relatively minimal benefits to users of reports on small and private businesses.

Users of these reports, on the other hand, appear reluctant to see the standards relaxed in any way. The debate on standards overload has reached somewhat of an impasse therefore.

This article suggests that it might be possible to escape this impasse if the parties to the debate:

(1) would differentiate carefully between (a) forms of disclosure, (b) alternative measurement bases, and (c) levels of attestation,

(2) would focus on the different types of information that various users already possess about the reporting company which they obtain independently of a regulated accounting report, and

(3) would consider the relationships between the users of financial information and the reporting company rather than the size of the company or whether it is public or private.

The first section of the paper provides a background to the complaints about standards overload. The second section develops the concept of marginal demand for regulated accounting information and suggests that this marginal demand varies with the distance of a user from the reporting company. The balance of the paper explores how these two concepts might form the basis of a new approach to standards overload. The article concludes with a possible solution to the problem but one that requires additional empirical research.

BACKGROUND

The AICPA:

In 1974 the AICPA, in response to numerous complaints that accounting pronouncements were imposing a standards overload on many companies, created the Werner Committee on Generally Accepted Accounting Principles for Smaller and/or Closely-Held Businesses. This committee in its 1976 report recommended the institution of reviews and compilations by accountants as an alternative to the standard audit.

The Derieux Committee on Small- and Medium-Sized Firms which followed in 1978 recommended the appointment of a special committee to "study alternative means of providing relief from accounting standards which are not cost effective for small businesses." The result was the Scott Committee on Accounting Standards Overload which by 1983 was "convinced by all the evidence considered that accounting standards overload is a major problem and that its burden falls disproportionately on small, nonpublic businesses and the CPAs who serve them."

They concluded, inter alia, that to "the extent that simplicity and flexibility is not feasible...differential disclosure alternatives (based on the criteria in the Werner Committee Report) as well as differential measurement alternatives" be considered. The Committee also referred accountants back to the Werner Committee's solution noting that "small, nonpublic entities can gain some measure of relief from accounting standards overload by issuing compiled, reviewed, or audited financial statements prepared on a comprehensive basis of accounting other than GAAP in accordance with existing disclosure and measurement standards and with the existing reporting requirements for CPAs."

Two basic factors emerge from this brief introduction. First, accountants are aware that the problem of standards overload will have to be addressed through differential attestation as well as differential disclosure and measurement. The first response of the AICPA, in fact, was not to define what should be disclosed or to dictate how it should be measured but to enable accountants to provide users with varying levels of assurance about the fairness of the information. It is not clear, though, that users understand how these three approaches interrelate.

Second, it is apparent just from the names of the committees that standards overload has been associated with certain types of companies; specifically, private companies, closely-held companies, and small companies. The conclusions of successive committees reinforce this perception. By contrast, relatively little has been said about how users, their characteristics, and their need for information differ except by implication.

The FASB:

In November 1981, the FASB instituted a survey entitled, Financial Reporting by Privately Owned Companies: Practices and Views" as a partial response to the conclusions of these various AICPA committees. One major result to emerge was evidence of a conflict of views between users and accountants.

* A majority of the 343 public accountants who responded felt that there was indeed a standards overload that adversely affected the small and private company. This corresponds with the convictions of the Scott Committee of course.

* A sizeable majority of the 193 non-manager users of financial information who responded were against any form of alternative disclosure. These users indicated that the types of decisions that they took and the kinds of

information that they used in these decisions were unaffected by the size of the company or by the nature of their holdings in the company, if any.

* The 283 managers who responded expressed less dissatisfaction than public accountants regarding standards overload but a significant minority had reservations about present rules for accounting for leases and taxes.

The accountants and the users clearly differed in their opinions and managers were somewhere in the middle. A careful reading of the survey yields other conflicts and questions. First, to what extent are users opposed to changes in disclosure rules, in measurement rules, in levels of attestation, or in all three? Do they even understand the difference between the three concepts? For example, we are told in the survey:

* Users believe that financial information has "greater reliability in most situations because of a public accountant's association with the financial statements" (FASB, p. 12). Attestation rather than disclosure appears to be the issue here.

* Some lenders "accept less financial information from a smaller company than from a larger one, particularly if the company and its owners are financially strong" (FASB, p. 12). In other words, the reliability of financial statements appears to be less important when the reporting parties are themselves reliable.

* "Almost [no users] were critical of specific measurement or disclosure requirements. Instead, the users focused their dissatisfaction on the level of CPA involvement...Many of them urged requiring a minimum level of review by outside CPAs to increase reliability..." (FASB, p. 17). Again attestation rather than disclosure appears to be the underlying cause for concern.

* "...follow up with selected lenders indicated that not all lenders understood that 'account for' was intended to embrace the possibility of different measurements as well as disclosures" (FASB, p. 14).

A second point is that, in spite of the apparent confusion at the conceptual level, it appears that at the practical level some users are making definite cost-benefit trade-offs between the three concepts. Banks, for instance, report that while they "have the ability to obtain information from a borrower apart from financial statements . . . they prefer to obtain most financial information from financial statements" (FASB, p. 11). This is hardly surprising because annual reports are free to users.

Summing up, the survey revealed that there are, on the one hand, users receiving information as a free good who do not see the need for differential standards based on company characteristics. They also do not appear to distinguish clearly between disclosure, measurement, and attestation. There are, on the other hand, accounting firms who appear to be experiencing very real standards overload. And in between is a management who were about equally divided regarding the desirability of different standards.

The FERF:

More recently the Financial Executives Research Foundation has published the results of its own survey entitled "Financial Reporting Requirements of Small Publicly Owned Companies." The conclusions of this study, which deliberately excluded private companies from its purview, are generally supportive of the positions reached by the FASB, although the FERF does carry these conclusions further wth respect to differential reporting.

The FERF survey clearly shows that management associates GAAP with measurement and, less clearly, with attestation. They perceive measurement to be the bailiwick of accountants, to involve primarily technical issues, and management wants no change in this area. (On what basis they reach this conclusion is unclear since they claim no technical competence in accounting measurement.) Disclosure is perceived to be distinct from GAAP and to affect the management of the firm more directly -- especially when it impacts negatively on their own company. Differential disclosure, especially in areas such as segment reporting, deferred taxes, and capitalized leases, unlike differential measurement, is supported by the majority of respondents.

USER DISTANCE

The primary focus of the overload debate, thus far, has been on the type of companies involved. It is quite plausible, though, that what is important are the relationships between the people who rely on financial information to make decisions and the company of interest. Indeed, as will be shown, these relationships are vital to an understanding of standards overload.

The first factor to note is that users vary widely in their involvement in the affairs of a company and on at least two dimensions:

(1) the frequency of interaction -- how often the individual interacts with the company -- daily, weekly, monthly?

(2) the scope of interaction -- is it broad and deep like that of a chief executive officer or relatively narrow and shallow like that of an employee on the production line?

Define then a user to be "close" to a company when the user's involvement with the company is frequent and deep. Conversely, define a user to be "distant" when the interaction is infrequent, is shallow, or is both. This concept of distance, as will be shown, enables one to predict both the nature of the information a user might require and the intensity of the demand for that information.

INFORMATION AVAILABILITY

Distance affects information availability. Typically when accountants think of information they think primarily of the transaction information that is collected, processed, aggregated, and distributed by the accounting system. This first type of information is available in raw form to a number of employees in management and in accounting. It is available as one moves up the hierarchy in increasingly more and more summarized form to management as budgets, forecasts, cost reports, and product line profitability reports. A formal, highly aggregated version of this transaction information goes to shareholders and other "outside users" at set periods of time in the form of quarterly and annual financial reports.

There are numerous other sources of information available in and about organizations, though. One source of information is user involvement with the affairs of a company. For example, a warehouse clerk learns about the company from booking deliveries, a banker from its flow of deposits and withdrawals, and a creditor from the speed with which payables are paid. Such information might be labeled interaction information. This second type of information is the most direct and is sometimes called firsthand information. This is the "target" information for management itself.

A third kind of information, often called indirect or secondhand information, flows in a relatively informal way to certain users. At luncheon or the country club, the owner of a company and its banker and lawyer, and people who do business with it discuss economic matters and the business. Through this process, these outsiders are able to fill in a picture both of the business and owner/manager who often guarantees the loans. This might be more true of small banks in small towns than large banks in large towns. Yet even in the latter, clubs, associations, and professional meetings, are part of a network of relationships which have an information dimension.

The abovementioned indirect information flows directly from the organization outwards. There are a number of sources, though, which are independent of the organization. These "secondary" sources include brokerage houses, business analysts, banks, merger specialists, and the like -- organizations which have great expertise in particular industries and play a key role in collecting seemingly unrelated bits of information and disseminating them in a coherent and useful form. Information must therefore be recognized as coming from many sources and varying widely in the directness of the path it takes.

User distance clearly affects information availability. The close user is by definition involved with the company on a regular and deep basis and is thereby deriving a great deal of firsthand, interaction knowledge about the company. In many cases that same close user will also be in possession of relatively disaggregated reports and be getting secondhand information from management -- if they are not managers themselves. Conversely, those who are not involved in the affairs of the business or are not dealing with the company on a day-to-day basis will (a) receive less information, (b) receive less detailed information, and (c) receive it less frequently.

INFORMATION RELIABILITY

Information availability is closely related to information redundancy which might be defined as the availability of the same information from two or more sources. At first glance, redundancy would appear to be wasteful of society's resources. On the other hand, sources of information can, and do, fail and society has an interest in ensuring the flow of information even at the expense of redundancy.

Redundancy, in other words, helps ensure information reliability to a user. One of the roles of auditing is to enhance the performance of the formal financial information system. To the extent that a user receives financial information from a variety of sources, this role might not be as necessary. There are many banks who have told selected clients that a full audit is unnecessary because they possess sufficient information about the company from other sources. The FASB survey provided further evidence of this practice.

Audited reports are necessary for those users who are essentially dependent on a single source for their information about the company. Such users are, by definition, distant from the company. Close users, by contrast, have a wide variety of information sources at their disposal and might feel the costs of a full audit to exceed the costs. In short, distance affects the perception a user has of the reliability of information.

DECISIONS

It also appears possible for distance to affect the nature of decisions that users take and thereby their overall requirements for information. Note first, that information is valuable only because it can be used to improve decisions. It is important, therefore, to examine information in the light of the decision which it attempts to support. Numerous types of decisions are made daily, of course, but they may all be usefully categorized for the purposes of this discussion in terms of their frequency.

At the one end of the spectrum are decisions that are taken infrequently. These often involve broad and usually long-range issues and are sometimes described as strategic decisions. Examples of such decisions on the part of a user might include buying or selling stock in a particular company or making a major loan to such a company. At the other extreme, there are decisions relating to a company that a user might make frequently. The decision of a supplier to make another sale to the reporting company on credit might be an example of a decision that is taken frequently.

Frequently made decisions typically concern small segments of a company and generally require information that is very current, rather detailed, although not precisely accurate. Such information, by its nature, cannot be audited. Less frequent decisions generally require less detailed and less frequent information but information that is broader and often more accurate. In short, different types of decisions require different types of information and different levels of attestation.

By definition, a user who is taking frequent decisions related to a company is, or should be, a close user. By contrast, the user who only takes infrequent decisions related to a company, such as the decision to sell its stock, is a relatively distant user. Of course, close users also take infrequent decisions; distant users, though, rarely take frequent decisions. It appears, therefore, that the nature of decisions that various users take usually relates to their distance from the company.

IMPLICATIONS

Several things flow from the observations above and specifically from the concept of user distance and its relationship to information availability and decision chacteristics.

Marginal Demand

The impact of user distance first on information availability and second on the nature of decision taken can be combined to show that the marginal demand for mandated accounting information relative to a given decision and for attestation of that information must vary with distance too.

(1) Distant users rarely make the sort of frequent decisions about a company that close users do. Hence, they have little requirement for information suitable for making these frequent decisions. On the other hand, they are involved in the less frequent, strategic type decisions, but since they are distant, they do not have an abundance of information at their disposal from informal sources. Thus, one might expect a high demand for mandated and attested information suitable for their decisions -- and this is a role formal accounting information can fulfil.

(2) Close users make a greater number and a greater variety of decisions than distant users but possess significant amounts of suitable information from a variety of sources. Thus, their marginal demand for mandated accounting information can be expected to be quite low for all types of decisions.

In short, if the above analysis is correct, the only demand for mandated accounting information should come from distant users and the only type of accounting information demanded will be that supporting infrequent decisions such as major loans to companies, or the purchase or sale of stock shares. A corollary to this is that the strongest demand for audited information will come from distant users. The FASB's survey and that of the FERF provide evidence supporting all these points.

Relationships

Specific company characteristics may now be seen to be largely irrelevant. Close users of all types have a low marginal demand for mandated accounting information, while distant users of all types have a potentially high demand for mandated accounting information related to the sorts of decisions taken infrequently and a low marginal demand for accounting information suitable for decisions taken more frequently. The arguments of the previous section that the marginal demand for accounting information is a function of the distance of a user from the reporting company applies to any company regardless of its size or complexity. In particular, therefore, it is most misleading to speak of a possible solution to standards overload in terms of company size implied in the expression "big GAAP versus little GAAP."

Equally, the nature of the user is irrelevant. For instance, a bank in a small town who carries the accounts of both the reporting company and its owner, who is familiar with the product or services of the company, and who might be familiar with many of its customers, is a close user. That same bank carrying the accounts of nonresidents, who maintain their personal accounts elsewhere, and whose products are sold out of town, is a distant user.

The question is one of relationships. It is the network of relationships that exist between a reporting company and the user that determines the user's distance. This is a concept that appears to be completely new to the debate on accounting standards overload but one that can lead to an objective way of examining the need and desirability for different reporting requirements.

A PROGRAM

The preceding analysis of relationships suggests a possible program for the solution of standards overload:

The first step would be a careful study of user requirements which might reveal that some accounting disclosure standards can be simplified for all companies because those users who do desire this information already have it, or have easy access to it, while all other users do not require it at all. Such studies could lead to the simplification of disclosure and measurement rules.

The second step would involve research into user benefits and producer costs and might further reveal that the present single, all-purpose report is not suitable for any of the classes of users -- specifically it may be marginally effective in fulfilling the requirements of the distant user and quite inefficient in serving the needs of the close user.

A third step would involve finding circumstances where differential rules, available to all companies, regardless of their size or ownership, would be dependent only on the various relationships the company has with different classes of users. These rules would differentiate between levels of disclosure, measurement, and attestation. The AICPA has already permitted differention in attestation with the creation of compilations and reviews alongside the audited report. The FASB has set precedents for differentiation in disclosure and measurement in the areas of segment and inflation accounting among others. Why not extend this on a more systematic basis?

The FASB's survey gives some preliminary evidence that differentiation based on relationships is already occurring informally since the majority of the small banks who responded do think that small companies can report differently "without reducing the usefulness of their financial statements to" the bank concerned (FASB, p. 14). This was not true of the responses of large banks -- which tends to suggest the concept of distance is already at work. The FERF's survey provides additional evidence since small public companies and small private companies were found to differ in their beliefs regarding standards overload.

The intent of this paper, though, is not to suggest a specific solution to standards overload but to outline a conceptual framework within which a solution might be achieved. In particular, if the analysis has been correct, further debate on the issue that is based on company characteristics, such as their being small or closely held, is doomed to failure. Instead the debate must shift to consider (a) the value of additional information to users and (b) the value of attested information to users, in the light of the relationships that exist between them and the reporting company. In short, in light of their distances from the company.

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